IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED: 18/09/2002

CORAM

THE HONOURABLE MR.JUSTICE V.S.SIRPURKAR
and
THE HONOURABLE MR.JUSTICE N.V.BALASUBRAMANIAN

T.C.No.1270 of 1988

M/s.George Maijo & Co., (Vizag),
Madras. ..... Applicant

-Vs-

The Commissioner of Income-tax,
Madras. ..... Respondent

Reference arising out of the order of the Income-tax Appellate Tribunal, Madras Bench-A, dated 15.12.1987 in ITA No.2867/Mds/85, at the instance of the assessee.

!For applicant :: Mr.P.P.S.Janarthana Raja

^For respondent :: Mr.T.C.A. Ramanujam, Sr.St.Counsel for IT.

:ORDER

N.V.BALASUBRAMANIAN,J.

The assessee is a firm consisting of five partners. The assessee with another firm, by name, M/s.George Maijo Associates formed a consortium and constituted a partnership firm, called M/s.United Exports. The United Exports is also a firm consisting of two partners, viz., Andrew G.Pattamana and Rita Joseph representing the assessee herein. The assessment year with which we are co ncerned is 1981-82 and the relevant previous year for the said assessment year ended on 30.6.198 0. In the accounts of the consortium, United Exports for the year ending 30.6.1980 the assessee was debited with the share of expenditure incurred which included the cost of certain goods which was claimed to have been lost at high sea. The transaction relating to the loss of goods arose out of the import of P.V.C. Resin suspension Grade. The United Exports entered into a C.I.F. (cost, insurance, freight) contract on 11.6.1979 with M/s.Palmex Enterprises, Singapore for the import of 800 Metric tonnes (M.T.) of P.V.C. Resin at the rate of 780 U.S. Dollar per M.T. The shipment was to be made by 30th September,197 9 and payment was to be made by way of an irrevocable letter of credit.

2. The United Exports requested the Bank of India, Bombay to

open a letter of credit and the bank issued a letter of credit for a sum of Rs.51,18,950/-. The United Exports took an insurance policy from the New India Assurance Co. Ltd. for Rs.55 lakhs in respect of the goods as per cover note No.25556 dated 29.6.1979 valid up to 29.9.1979 . On 17.8.1979, United Exports took another cover note for Rs.22 lakhs with New India Assurance Co. Ltd. for profit insurance. The foreign seller, M/s.Palmex Enterprises presented the bills along with the copy of invoice, packing list and certificate of origin to the Bank of India for payment and the bank made the payment on 21.8.1979. The United Exports then received a presentation memo on 22.8.1979 from the bank informing the arrival of the documents. On 12.9.1979, United Exports received a cable from M/s.Palmex Enterprises stating that it was understood from the owners/agents of the vessel 'Averilla' that the vessel sank with cargoes on 8th September,1979 150 miles off Colombo. Therefore the United Exports did not retire the documents from the bank and instead, the United Exports made a claim with New India Assurance Co. Ltd. and also filed a Summary suit No.800 of 1980 on the file of the High Court of Judicature at Bombay against New India Assurance Co. Ltd. Since the amount was not paid by the United Exports, the Bank of India also filed a Summary suit No.1677 of 1981 on the file of the High Court, Bombay against the United Exports for recovery of the amount due to it. In the accounts of the United Exports for the year ending 30.6.1980, the value of the goods lost in transit amounting to Rs.51,18,950/- was reduced from the value of the closing stock.

3. Subsequently, there was a C.B.I. enquiry and it was found that the ship, Averilla had sunk under mysterious circumstances and the partners of M/s.Palmex Enterprises were prosecuted for an act of conspiracy along with a partner of another concern, called M/s.Orient Enterprises before the Sessions Judge, Singapore and they were convicted. It is relevant to mention here that the import of P.V.C. Resin was undertaken at the instance of Imperial Industrial Corporation which was a dummy for Orient Enterprises, though no concluded written agreement existed between United Exports and Imperial Industrial Corporation. A sum of Rs.5 lakhs paid as advance by Imperial Industrial Corporation was taken into account by United Exports since it was not demanded back by Imperial Industrial Corporation. The report of the C.B. I. revealed that the accused had conspired to obtain a second-hand vessel in which they had loaded drums containing coloured water to pass it off as oil and packed rice-bran as other goods such as cloves and arranged with the Captain to scuttle the ship in the high seas. In other words, in pursuance of the conspiracy, the United Exports was induced on behalf of a dummy firm, M/s.Imperial Industrial Corporation showing it to be the actual user of P.V.C. Resin for opening the letter of credit in favour of the Singapore firm. There were number of parties who were victims of the conspiracy and one of them was the United Exports.

4. The assessee, on the basis of debit entry made by United Exports, claimed that a sum of Rs.51,18,232/- should be allowed as business expenditure. The Income-tax Officer rejected the claim of the assessee on the ground that United Exports obtained the licence and it was only United Exports who entered into an agreement with M/s.Orient Enterprises, New Delhi and M/s.Siraj & Co., Bombay for the import of P. V.C. Resin and Palm Oil. He also found that only the United Exports opened the letter of credit with the Bank of India and United Exports arranged for the insurance of goods and filed suit against the insurance company. Accordingly, the Income-tax Officer was

of the opinion that the loss could be claimed only in the hands of M/s.United Exports and not in the hands of the assessee. He was also of the opinion that even in the hands of United Exports the liability was not crystallised. The Inspecting Assistant Commissioner, who was associated in the assessment proceedings, was also of the opinion that the consortium was nothing but a group of certain parties with the object of achieving certain results for earning income. He was of the opinion that the United Exports did not act as an agent for the constituent units. He agreed with the Income-tax Officer that it was the United Exports which had imported the goods and the loss so occurred had to be considered in the hands of the United Exports. In other words, according to the Inspecting Assistant Commissioner, there was no direct nexus between the loss occurred and the activities of the assessee. In this view of the matter, the claim of the assessee for deduction for a sum of Rs.51,18,950/- was rejected. However, the Inspecting Assistant Commissioner in his order refer red to a figure of Rs.55,06 ,706/- instead of Rs.51,18,950/-.

5. The assessee filed an appeal against the order of assessment before the Commissioner of Income-tax (Appeals). The Commissioner of Income-tax (Appeals) found that the loss of Rs.55,06,706/- consisted of the actual loss on import of Rs.54,26,268/- and a sum of Rs.80,438/- being expenses incurred by the United Exports on behalf of the assessee. He held that the assessee entered into an agreement with the United Exports and the United Exports acted as a medium to channelise the export activities of the member units with the permission of the Government of India. He was of the view that after obtaining import entitlements on behalf of the member units, the goods were shipped and if any loss arose, the loss would be a loss of stock-in-trade as far as the member units are concerned. He therefore held that the loss arose out of a completed transaction. He held that as far as Bank of India is concerned, the transaction with regard to import was completed at the moment when it negotiated the letter of credit and paid the amount covered by the letter of credit and thereafter made a claim against the United Exports for full value despite the fact that the goods did not reach the United Exports. He held that the loss in the transit has to be borne by the importer. He held that the fact that goods never reached the assessee showed that the assessee could be deemed to have sustained the loss. As far as the liability of the Bank of India is concerned, the reason for non-arrival of the goods is immaterial. He also found that the insurance claim was rejected and therefore he held that the entire sum of Rs.55,06,706/- would be allowed as a deduction. The Commissioner of Income-tax (Appeals) allowed the appeal preferred by the assessee on this point.

6. The Revenue preferred an appeal challenging the order of the Commissioner of Income-tax (Appeals) before the Income-tax Appellate Tribunal. The Appellate Tribunal found that the report of the C.B.I. could not be ignored and the goods contracted to be purchased by the United Exports were not actually put on board 'Averilla'. The Appellate Tribunal held that the bill of lading did not refer to the actual goods and hence, it is not possible to accept the claim of the assessee that the closing account of the United Exports should be reduced by an amount equivalent to the value of the goods. The Appellate Tribunal also found that the bank filed a suit and the United Exports also filed a suit against the Insurance Company. The Appellate Tribunal was of the view that the right of the bank to receive payment is

itself a dispute and consequently the liability cannot be said to have accrued in the previous year relevant to the assessment year in question. In this view of the matter, the Appellate Tribunal felt that it is not necessary to decide the question whether the United Exports had actually suffered any real loss in the previous year by cheating and as long as the United Exports has a recourse both against the bank and the Insurance Company, it could not be said that the United Exports had actually incurred any loss. The Appellate Tribunal also rejected the contention made on behalf of the Revenue that the loss incurred by the United Exports could not be allowed in computing the income of the assessee. The Appellate Tribunal held that the United Exports acted only as an agent and carried on the transaction for and on behalf of the constituent units and all expenses or losses incurred by the United Exports have to be borne by the principals, viz., the units. The Appellate Tribunal therefore held that the admissible loss properly apportioned between the two constituent units has to be allowed in the hands of the assessee in computing the income. The Appellate Tribunal therefore allowed the appeal preferred by the Revenue. Dissatisfied with the order of the Appellate Tribunal, the assessee sought for a reference and the Appellate Tribunal has stated a case and referred the following question of law for our consideration:-
" Whether on the facts and circumstances of the case, the assessee is entitled to deduction of the sum of Rs.51,18,950/- being amount debited to its account by United Exports and allocated to the assessee?"

7. Mr.P.P.S.Janarthana Raja, learned counsel for the assessee submitted that the Appellate Tribunal was not correct in holding that the assessee did not incur any liability during the previous year relevant to the assessment year in question. According to him, when the Appellate Tribunal has accepted that there was a valid consortium and United Exports acted only as agent of the consortium, the assessee as a constituent of the consortium is entitled to the allowance of the amount debited to its account by the United Exports, that is, the share of expenditure incurred towards the goods which were lost at high sea. His submission was that the goods were stock-in-trade of the assessee and so long as the assessee was not a party to the conspiracy that might have been entertained between the foreign seller, viz., Palmex Enterprises, Singapore and another concern, by name, Orient Enterprises, the assessee is entitled to get deduction of the share of expenses incurred in relation to the loss of the goods. His submission was that the bank has already paid money and though the liability to the bank is disputed, the liability was incurred by the assessee during the previous year in question and therefore the assessee is entitled to deduction. Learned counsel relied upon the decision of the Supreme Court in KEDARNATH JUTE MFG. CO. LTD. v. C.I.T. (82 ITR 363) and submitted that the liability does not cease to be a liability because the assessee had taken proceedings before higher authorities for getting it reduced or wiped out. Learned counsel also submitted that during the previous year, the bank paid the money and the bona fide of the transaction is not disputed and when the Appellate Tribunal has accepted that the assessee's title to the goods transferred by delivery of document, viz., bill of lading, it erred in applying the exception where there is no misrepresentation or fraud on the facts of the case. Learned counsel submitted that the assessee was cheated and when the loss occurred due to the loss of stock-in-trade to the assessee and when the liability arose during the

previous year relevant to the accounting year in question, the assessee is entitled to claim the amount as deduction. He also relied upon the decision of the Delhi High Court in C.I.T. v. BHARAT CARBON AND RIBBON MFT. CO. (239 ITR 505).

8. Mr.T.C.A.Ramanujam, learned counsel appearing for the department submitted that the department should have proceeded on the basis that there was no consortium and the assessment should have been made on the association of persons. He submitted that the loss did not arise during the previous year and accordingly, the debit is premature and since there was no ascertained loss, the assessee is not entitled to get deduction. Learned counsel submitted that the debit entry is not helpful and since the loss has to be ascertained, the assessee is not entitled to claim the deduction. Learned counsel relied upon the decision of this Court in VENKATACHALAPATHY IYER v. COMMR. OF INC.-TAX (20 ITR 363) and submitted that unless the loss is actual and certain, there could not be an accrual of loss. He therefore submitted that until settlement of the case by compromise, there is no loss at all and it is only then, that the loss would come into existence. Learned counsel also relied upon the following decisions:-

1. ASSOCIATED CLOTHIERS LTD. v. COMMR. OF INC.-TAX (63 ITR 224)

2. C.I.T. v. HINDUSTAN HOUSNG & LAND DEVPT. TRUST (161 ITR 524)

3. HOPKIN & WILLIAMS (TRAVANCORE) LTD. v. COMMR. OF INC.-TAX (64 ITR 76)
4. U.P.VANASPATI AGENCY v. COMMR. OF INC.-TAX (68 ITR 120)
5. COMMR. OF INC.-TAX v. SHEWBUX JAHURILAL (46 ITR 688)

9. At the outset, we mention that though Mr.P.P.S.Janarthana Raja, learned counsel produced before us a copy of the letter of the Assistant General Manager, Bank of India addressed to the United Exports, Chennai confirming that the suit instituted by the bank has been settled by payment, we are not referring to or placing any reliance on the said letter as the letter was not considered and could not have been considered by the Appellate Tribunal as the settlement seems to have taken place subsequent to the order of the Appellate Tribunal. We are of the view that in view of the decision in ASSOCIATED CLOTHIERS LTD. v. COMMR. OF INC.-TAX (63 ITR 224), this Court in a reference under section 256 of the Income-tax Act has no power to admit or record additional evidence which has not been placed before the Tribunal and to consider that evidence. Hence, we ignore the letter produced by the learned counsel for the assessee.

10. We also like to clear another matter also before proceeding further. The submission of Mr.T.C.A.Ramanujam, learned counsel for the Revenue is that the department has committed an error in not proceeding against the United Exports and the assessee herein as well as the other constituent unit, and should have made an assessment on the consortium as an association of persons. We are not expressing any opinion as to what the department should have done. We are also not expressing any opinion on the submission of the learned counsel for the Revenue and we are not inclined to give any direction also for making such an assessment.

11. Another point sought by Mr.T.C.A.Ramanujam, learned counsel for the Revenue is that the loss occurred is that of the United

Exports and it is not open to the assessee to claim the same in the computation of its income. We are of the view that it is not open to the Revenue to raise such a contention. We have already set out the facts. The Income-tax Officer as well as the Inspecting Assistant Commissioner in the tax assessment proceedings proceeded on the basis that the loss is that of the United Exports and if there is any loss, that could be claimed by the United Exports. The assessee preferred an appeal before the Commissioner of Income-tax (Appeals) and the Commissioner of Income-tax (Appeals) did not accept that view and held that the Income-tax Officer and the Inspecting Assistant Commissioner had not properly appreciated the circumstances in which the consortium was formed in order to get the benefit given by the Government for the customers. The Commissioner of Income-tax (Appeals) held that the United Exports acted only as a medium to channelise the export activities of the member units and after the goods were shipped, if any loss arose, that was a loss of stock-in- trade of the member units. The Commissioner of Income-tax (Appeals) therefore held that the assessee would be entitled to get deduction of the trading loss and allowed the appeal preferred by the assessee. The Revenue has challenged the deduction in the hands of the assessee before the Appellate Tribunal and the Appellate Tribunal rejected the contention urged on behalf of the Revenue that it was not the loss of the assessee, but that of the United Exports. The Appellate Tribunal found that the United Exports acted only as an agent and the rules also permitted the United Exports to carry on the transactions. The Appellate Tribunal also found that the profits on transactions were assessed in the hands of the constituent members and equally the loss should also be allowed as deduction in the hands of the members. The Appellate Tribunal therefore held that the proportionate loss should be divided between the two constituents and allowable in the hands of the assessee in the computation of its income. The finding of the Appellate Tribunal has become final as the Revenue has not challenged the finding by filing an independent reference application. Before the Appellate Tribunal the Revenue lost its case on the question whether the business loss was allowable in the hands of the assessee or not, and it is an independent question. Though the Appellate Tribunal decided that the loss is not a business loss in the previous year relevant to the assessment year in question, the Revenue could have asked for a reference on the question whether it was a loss of the assessee or that of the United Exports. Further, there was no application at all by the Revenue requesting the Appellate Tribunal to refer a question on the issue whether the loss is that of the assessee or that of the United Exports. In the absence of any such question of law referred by the Appellate Tribunal, we hold that it is impermissible for the Revenue to raise the question that the loss could not be claimed by the assessee at all and that the finding rendered by the Appellate Tribunal that it is open to the constituent units to claim the loss has become final.

12. In this connection, we would also like to mention that there were two transactions and the Appellate Tribunal held that as regards one transaction the loss was allowable in the hands of the assessee and in the case of other transaction, which is subject matter of the present tax case reference, the Tribunal held that the loss did not accrue in the previous year. The Appellate Tribunal independently went into the question and decided that the loss is that of the assessee and the United Exports acted only as an agent. Since the finding of the Appellate Tribunal has not been challenged by

filing an independent reference application requesting the Tribunal to refer the question, in the absence of any question before us, it is not open to the learned counsel for the Revenue to urge the point. This Court in E.I.D. PARRY LIMITED v. C.I.T. (174 ITR 11) has held that the Tribunal was not competent to refer a question suo motu and there must be an application either oral or written before the Tribunal. On the facts of the case, we find that there was neither an oral request, nor a written application before the Tribunal and the Tribunal has also not referred a question as sought to be canvassed by the learned counsel for the Revenue. In the absence of any application or reference by the Tribunal, we hold that it is not open to the learned counsel for the Revenue to raise such a point in the reference at the instance of the assessee. Accordingly, we decline to entertain the plea of the learned counsel for the Revenue.

13. Mr.T.C.A.Ramanujam, learned counsel for the Revenue strongly relied upon the decision of this Court in VENKATACHALAPATHY IYER v. COMMR. OF INC.-TAX (XX ITR 363). In that case, the assessee was a firm carrying on business as yarn merchants and the assessee employed a clerk who wrote account books as well as acted as salesman. He also received and disbursed cash in the absence of the managing partner and collected bills. The clerk noted the amounts received and spent by him in the course of the day on slips of paper and handed over the slips with cash balance in his hands to the managing partner at the close of the day. The clerk embezzled certain money and he entered the transactions in the books maintained by him, but he short-totalled the receipts and over-totalled the payments and prepared a statement of daily cash balance on the basis of such wrong totals and handed over to the managing partner at the end of the day only the cash as per that statement. A criminal complaint was filed against him and a civil suit was also filed for recovery of the amount and the matter was compromised in the month of August, 1941. The assessee claimed deduction of the amount embezzled in the assessment proceedings for the assessment year 1942-43. This Court held that though the misappropriation was found in 1941, the amount was entered in the accounts as a debit against the clerk at the end of the previous accounting year and until the settlement of the case by way of compromise, there was no loss at all.

14. Mr.T.C.A.Ramanujam, learned counsel also referred to the decision of the Supreme Court in ASSOCIATED BANKING CORPORATION OF INDIA LTD. v. C.I.T. (56 ITR 1) wherein it was held that so long as there is a prospect of recovery of the moneys embezzled, trading loss in the commercial sense cannot be deemed to have resulted with. In this connection he also relied on the decision of the Kerala High Court in HOPKIN & WILLIAMS (TRAVANCORE) LTD. v. COMMR. OF INC.-TAX (LXIV ITR 7 6) and the decision of the Allahabad High Court in U.P.VANASPATI AGENCY v. COMMR. OF INC.-TAX (68 ITR 120) wherein it was held that if the assessee made necessary attempts to recover the loss from the persons, but failed or if the assessee did not make such attempts because it was useless to make them in view of the financial position of the person concerned, then and then alone the loss could be allowed. Learned counsel relied on those decisions and submitted that the assessee has not taken any step to recover the money lost either from the United Exports or from the foreign seller and since the assessee has not taken steps to recover the loss, the loss could not be said to have occurred enabling the assessee to claim deduction.

15. We are unable to accept the submission of the learned counsel for the Revenue. There is no dispute that the contract entered into was a C.I.F. contract for the purchase of certain articles and the shipment was to be made on 30.9.1979 and payments were required to be made by an irrevocable letter of credit. The foreign seller issued sixteen bills of lading dated 6.8.1979 and presented the bills along with a copy of invoice, packing list and certificate of origin to the Bank of India for payment and the bank made payment on 21.8.1979 and the united Exports also received a presentation memo on 22.8.1979 from the bank informing the arrival of the documents. Though we are not concerned with the question whether the bank was right in making payment but for deciding the issues that arise in the case, we are of the opinion that the question of legal effect of opening letters of credit has to be considered. 16. The Supreme Court in number of cases considered the legal effect of opening letters of credit and payments made by the bank in pursuance of letters of credit. The following observations in U.P.C.F. LTD. v. SINGH CONSULTANTS AND ENGINEERS (P) LTD. (1988) I SCC 174) are relevant for the purpose of this case:-

" 29. In Tarapore & Co., Madras v. M/s.V/O Tractors Export, Mascow (1969) 2 SCR 920: (1969) 1 SCC 233: AIR 1970 SC 891), this Court observed that irrevocable letter of credit had a definite implication. It was independent of and unqualified by the contract of sale or other underlying transactions. It was a mechanism of great importance in international trade and any interference with that mechanism was bound to have serious repercussions on the international trade of this country. The court reiterated that the autonomy of an irrevocable letter of credit was entitled to protection and except in very exceptional circumstances courts should not interfere with that autonomy.

31.The Court however observed that the opening of a confirmed letter of credit constituted a bargain between the banker and the seller of the goods which imposed on the banker an absolute obligation to pay. The banker was not bound or entitled to honour the bills of exchange drawn by the seller unless they and such accompanying documents as might be required thereunder, were in exact compliance with the terms of the credit.

44. The modern documentary credit had its origin from letters of credit. We may, therefore, begin the discussion with the traditional letter of credit. Paul R.Verkuil in an article ('Bank Solvency and Guaranty Letters of Credit', Stanford Law Review, V.25 1972-73 at p.719) explains the salient features of a letter of credit in these terms:

The letter of credit is a contract. The issuing party – usually a bank – promises to pay the 'beneficiary' - traditionally a seller of goods – on demand if the beneficiary presents whatever documents may be required by the letter. They are normally the only two parties involved in the contract. The bank which issues a letter of credit acts as a principal, not as agent for its customer, and engages its own credit. The letter of credit thus evidences – irrevocable obligation to honour the draft presented by the beneficiary upon compliance with the terms of the credit.

45. The letter of credit has been developed over hundreds of years of international trade. It was most commonly used in conjunction with the sale of goods between geographically distant parties. It was intended to facilitate the transfer of goods between distant and unfamiliar buyer and

seller. it was found difficult for the seller to rely upon the credit of an unknown customer. It was also found difficult for a buyer to pay for goods prior to their delivery. The bank's letter of credit came into existence to bridge this gap. In such transactions, the seller (beneficiary) receives payment from issuing bank when he presents a demand as per terms of the documents. The bank must pay if the documents are in order and the terms of credit are satisfied. The bank, however, was not allowed to determine whether the seller had actually shipped the goods or whether the goods conformed to the requirements of the contract. Any dispute between the buyer and the seller must be settled between themselves. The courts, however, carved out an exception to this rule of absolute independence. The courts held that if there has been 'fraud in the transaction' the bank could dishonour beneficiary's demand for payment. The courts have generally permitted dishonour only on the fraud of the beneficiary, not the fraud of somebody else.

53. Whether it is a traditional letter of credit or a new device like performance bond or performance guarantee, the obligation of banks appears to be the same. If the documentary credits are irrevocable and independent, the banks must pay when demand is made. Since the bank pledges its own credit involving its reputation, it has no defence except in the case of fraud. The bank's obligations of course should not be extended to protect the unscrupulous seller, that is, the seller who is responsible for the fraud. But, the banker must be sure of his ground before declining to pay. The nature of the fraud that the courts talk about is fraud of an 'egregious nature as to vitiate the entire underlying transaction'. It is fraud of the beneficiary, not the fraud of somebody else. If the bank detects with a minimal investigation the fraudulent action of the seller, the payment could be refused. The bank cannot be compelled to honour the credit in such cases. But it may be very difficult for the bank to take a decision on the alleged fraudulent action. In such cases, it would be proper for the bank to ask the buyer to approach the court for an injunction."

17. We have quoted the judgment in extenso to clarify the role of a bank in honouring a letter of credit. The Bank of India has duly made payment on presentation of documents. The bank has also informed the United Exports about the arrival of the documents. Though the ship sank in high seas, the consortium, United Exports claimed the amount on the basis of the accounts maintained by it wherein the assessee was debited with the share in the expenditure which includes the cost of the goods which had been claimed as lost in high sea. The report of the C.B.I. is dated 6.8.1994 and the assessment year with which we are concerned is 1981-82 with the relevant previous year ending 30.6.1980. We are of the view that the fact that the bank had made payment to the foreign seller in honouring the letter of credit taken out by the United Exports and the fact that the ship sank in high sea during the relevant previous year and the further fact that there was a debit entry in the accounts of the United Exports because of the loss of goods cannot be overlooked in determining the question whether the loss had occurred during the previous year ended on 30.6.1980. Though it is permissible to look into the subsequent events, yet, it is difficult to visualise that the assessee should wait for the finalisation of its accounts till the C.B.I. investigation is over and the C.B.I. submits its report. It is also relevant to notice that in the report of the C.B.I. there was no indictment either

against the assessee or against the United Exports and it was only against the foreign seller and another firm, called Oriental Enterprises the indictment was made. It is not the case of the Revenue that the assessee or the United Exports was a party to the fraud committed by the foreign seller. In our view, when the ship was alleged to have sunk in high sea, it is open to the assessee to take note of the actual payment by the bank in honouring the letter of credit taken out by the United Exports and the actual sinking of the ship for claiming the amount as a trading loss. Though the United Exports resisted the suit instituted the bank, the mere fact that the liability was disputed is not a ground to hold that the loss did not accrue.

18. We are of the view that the decisions relied on by Mr.T.C.A. Ramanujam, learned counsel for the Revenue have no application as in those cases, there was embezzlement and the courts have taken the view that unless accounts were settled, the assessee could not claim any loss. On the other hand, on the facts of the case, when the assessee bona fide thought that there was no prospect of recovery of value of the goods which had sunk in the sea for which the bank had already made payment and debit entry was made by the United Exports against the assessee, we hold that the loss arose during the previous year relevant to the accounting year in question. As already observed by us, the mere fact that the United Exports contested the liability is not a ground to hold that there was no accrual of liability.

19. In our view, it is profitable to view the transaction from another angle as well. Let us assume, the assessee had placed direct orders with the foreign seller and the letter of credit was also opened at the request of the foreign seller and after making payment by the bank in honouring the letter of credit, the vessel which carried the goods sank in the high sea. In such a situa tion, it is not expected that the assessee should file a suit against the foreign seller and depend upon the outcome of the suit whether the amount should be written off or not. Equally, it cannot be stated that the loss would occur in the year in which final decree was passed in the suit. The fact that the goods loaded in the ship had lost in the high sea for which the assessee had to make payment to the bank would show that the liability to make payment had fallen on the assessee and in the absence of any possibility for the assessee to get back the stock-in-trade lost in the high sea, the assessee would be justified in claiming the same as a trading loss in the year in which the ship had sunk in the high sea. Therefore the mere fact that the United Exports acting on behalf of the assessee resisted the suit instituted by the bank is not relevant when the ship had sunk in the high sea. Further, neither the assessee, nor the United Exports was a party to the fraud committed by the foreign seller.

20. We are of the view that it is also permissible to look the matter from another angle. The assessee was a member of the consortium and on the basis of the agreement with the United Exports, it was found that the United Exports was acting as a medium to channelise the export activities of the member units. The assessee requested the United Exports to import goods and had the assessee paid the full value of the goods, there would have been a credit entry in favour of the assessee in the book of the United Exports. Had the goods been received by the United Exports and delivered to the assessee, corresponding entry cancelling the credit entry would also have been made in the delivery account and the United Exports might at least be entitled to commission as agreed upon in the agreement. The assessee

apparently had not paid the value of the goods at the time of placing orders to import goods. Since it was an international trade, letter of credit was opened with the Bank of India by the United Exports and the bank also paid the money on presentation of documents by the seller. Consequently, the United Exports became liable to pay money to the bank, even though it was disputing the liability. In the meantime, the goods lost in the high sea with the result, the United Exports had made debit entry against the assessee and made a claim against the assessee for the full value of the goods. As far as the assessee is concerned, even in the absence of receipt of goods, the liability has fallen on it to pay the value of the goods and in that sense, the loss has occurred to the assessee. The United Exports claimed the money from the assessee and the assessee also accepted the same and that would constitute a prima facie evidence that the loss had occurred during the previous year relevant to the assessment year. The assessee has admittedly maintained its books on mercantile basis. We are of the view that the assessee is entitled to claim deduction of the loss irrespective of the fact that the United Exports had contested the suit filed by the bank or the money was not paid to the bank by the United Exports.

21. The Supreme Court in RAMCHANDAR SHIVNARAYAN v. C.I.T. (111 ITR 263) held that it is open to the assessee to claim the loss if it has a proximate connection with its business. Hence, it is settled that the loss arising by embezzlement of money by a stranger to the business is also a trading loss and the loss is liable to be allowed as deduction provided the loss is incidental to the normal operation of the business.

22. Applying the tests laid down by the Supreme Court, we are of the view that when there is a direct intimate connection between the business operation of the assessee and the loss that has fallen on the assessee, though the loss was occasioned by the act done by the seller, since the assessee is not stated to be a party to the fraud committed by the foreign seller, the loss would be allowable as deduction as the loss is incidental to the business carried on by the assessee. As observed by the Supreme Court in MADRAS INDUSTRIAL INVESTMENT CORPORATION LTD. v. C.I.T. (225 ITR 802), where the liability was incurred which has to be discharged in a future date, it will be a liability, but however, a contingent liability which may have to be discharged in future cannot be considered as expenditure. In our view, it is not a case of contingent liability as the liability has arisen during the previous year relevant to the assessment year in question.

23. The Tribunal disallowed the loss only on the ground that the loss did not arise during the previous year relevant to the assessment year. In our view, the Tribunal has misdirected itself in this matter as it has focussed its attention only to the suit instituted by the bank and the resistance of the suit by the United Exports. We are of the view that whatever may be the stand taken by the United Exports in the suit instituted by the bank, the undisputed facts are that the bank has paid the money to the foreign seller on the basis of the letter of credit and corresponding debit entry has been made against the assessee by the United Exports.

24. In this connection, it is also relevant to notice that the report of the C.B.I. was filed only on 30.6.1994, and it is not expected of the assessee to keep its accounts pending till the C.B.I. filed its report. The Central Board of Direct Taxes taking note of the ground realities of the situation in commercial transactions, has issued a circular dated

24.11.1965 directing the assessing officers to allow the loss arising by embezzlement in the year in which it was discovered and claimed. The circular is applicable to the facts of the case as the assessee had bona fide entertained the view that the loss of stock-in-trade arose during the previous year in question. In our view, it is a case of cheating by the seller and so long as the assessee was not a party to the cheating, the assessee is entitled to claim the loss.

25. We are also unable to accept the reasonings of the Tribunal that the loss had not occurred in the relevant previous year. We have already found that the ship had sunk and money was paid by the bank to the foreign seller and the United Exports made debit entries against the assessee, and in our view, all these factors would establish that the loss had occurred during the previous year. As observed by the Supreme Court in RAMCHANDAR SHIVNARAYAN v. C.I.T. (111 ITR 263), when there is a direct and proximate nexus between the loss and the business operations, then the loss is deductible as the loss is incidental to the carrying on of the business. The Supreme Court held that the question whether loss has occurred or not has to be decided from the commercial point of view. The assessee in the normal course of business would have imported certain stock-in-trade and had the stock-in-trade arrived and sold by the assessee, the profit or loss on the sale of stock-in-trade would be taken into consideration in the assessment of the assessee. Similarly, if the goods were lost in high sea, there is no difficulty in holding that the assessee is entitled to deduction. The difficulty in this case has arisen because the seller had not exported the goods contracted to be purchased, but cheated the assessee. The position would have been different if the liability of the assessee to pay the value of the goods had arisen on the sight of the goods. However, on the facts of the case, since the letter of credit was opened and the bank made payment on the presentation of documents, the assessee was obliged to pay for the value of the goods. We therefore hold that the loss had fallen on the assessee and hence, it is deductible in the computation of the assessee's total income. In other words, the loss was incidental to the carrying on of the business of the assessee and there is a direct and proximate connection between the business operations of the assessee and the loss that occurred.

26. We are of the view that the debit entry made by the United Exports is a honest and bona fide one and so long as the debit entry is existing at the time of finalisation of accounts of the assessee, the assessee was justified in claiming the same as a business loss. Though the United Exports pursued the matter against the Insurance Company and resisted the suit filed by the bank, that is not relevant in considering the question whether the loss has fallen on the assessee. We are therefore of the opinion that the loss incurred by the assessee is a trading loss. In the peculiar circumstances of the case in which the assessee was not a party to the fraud, the loss occurred during the previous year relevant to the assessment year in question. No doubt, it is made clear that if the Insurance Company reimburses the money to the assessee, the question whether it is taxable or not would arise in the year of reimbursement. However, on the facts of the case, we are satisfied that the loss occurred because of the loss of goods said to have exported by the foreign seller in the foreign soil. Accordingly, we do not approve the view of the Tribunal that the assessee is not entitled to claim the deduction of the amount as a business loss. Accordingly, we answer the

question referred to us in the negative, in favour of the assessee and against the Revenue. There will be no order as to costs.

Index: Yes
Website: Yes
na.
(V.S.S.,J.)(N.V.B.,J.)

To

1.The Asst. Registrar,
Income-tax Appellate Tribunal,
Rajaji Bhavan, III Floor,
Besant Nagar, Chennai (5 copies).

2.The Secretary, Central Board of Revenue,
New Delhi (3 copies).

3.The Commissioner of Income-tax, Madras.

4.The Income-tax Officer, City Circle II(1), Madras.